Finance Watch

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Can Securitisation Reboot the Capital Markets Union?

The limits of recent policy proposals to 'revive' the market for asset-backed securities in Europe

A Finance Watch Position Paper

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Introduction

This position paper attempts to step back from the current excitement around securitisation and, in general terms, outline its potential contribution for the real economy, its interactions with other parts of the financial system, and the attendant balance of opportunities and risks. Further details on the underlying mechanics of securitisation are available in Finance Watch's 'Introduction to Securitisation' position paper from 25 October 2024,[1] as well as its comprehensive 2014 report.[2]

Key Takeaways

1. The potential contribution of securitisation to the Capital Markets Union (CMU) is doubtful and, in any event, limited. Less than one-third of European securitisations (ca. EUR 60 bn in 2023) are actually placed on the capital markets while the remainder are either retained by the originating bank, or held by other banks as collateral to obtain central bank liquidity.
2. The prevailing objective of securitisation is for banks to reduce regulatory capital requirements by removing assets from their balance sheet and/or transferring the associated credit risk. There is no obligation for banks to redeploy 'freed up' regulatory capital towards lending.
3. Promoting securitisation, especially to refinance mortgages, is likely to interfere with some of the few successful segments of the EU capital markets, namely plain covered bonds and Pfandbriefe, which are proven, high-quality instruments. Unlike these instruments, securitisations are structured instruments, and ill-suited for retail investors.
4. The notion of 'de-risking' banks by providing a securitisation platform supported by public guarantees – copying the US model – is conceptually unsound. Instead of providing public support directly to the real economy, this proposal would again place the public at risk in order to 'de-risk' the business of the banking sector.
5. Post-crisis measures to address the risks of securitisation were agreed and enacted at the global level and should be reviewed and amended in the same way. EU legislation already deviates from the Basel III standards. EU legislators should engage with other jurisdictions to return towards regulatory convergence.

I. Background: Recent policy initiatives

After years spent restoring a reputation tarnished by its role in the global financial crisis of 2007/09, securitisation is back on the European agenda. At the April 2024 European Council, EU leaders called for a 'new European competitiveness deal' by advancing work on

[1] Finance Watch, Introduction to Securitisation. Structures, regulation and market for asset-backed securities in the EU, 25 October 2024.

[2] Finance Watch, A Missed Opportunity to Revive 'Boring' Finance? A Position Paper on the Long Term Financing Initiative, Good Securitisation and Securities Financing, 01 December 2014.

the Capital Markets Union (CMU), and 'relaunching the European securitisation market.'[3] Also in April, the report by Enrico Letta's report on the Single Market[4] stressed the benefits of securitisation as a 'unique link between credit and capital markets'. In May, the European Securities and Markets Authority (ESMA) called upon the Commission to 'put forward a proposal aiming to revitalise the EU securitisation market'.[5] More recently, Mario Draghi's report highlighted securitisation as a possible 'substitute for the lack of capital market integration'.[6]

The fact that securitisation, a financial technique which had arrived in Europe only a few years before the global financial crisis of 2007/09, has gone from being one of the root causes of that crisis to become the 'great white hope' of EU financial policymakers is both remarkable and unsettling. European policymakers' expectations for the contribution of securitisation to the funding challenges of the EU economies over the coming years are not realistic.[7]

Why this apparent fixation on securitisation? Arguably, securitisation is, first and foremost, a project of the European banking sector. As of today, banks dominate the financial sector in Europe: they account for 90% of household debt and 70% of business debt.[8] Securitisation cements the role of banks as the dominant financial intermediary between borrowers and capital markets. It is attractive for banks for a number of reasons – regulatory capital relief, improved performance metrics, additional fee income – which are particularly compelling for large banks that compete internationally. This line of argument has particular resonance with EU policymakers, but fails to address the structural causes at the root of EU banks' lack of competitiveness.

The current international and EU regulatory framework for securitisation is summarised in the Finance Watch's position paper, "Introduction to Securitisation: Structures, regulation and market for asset-backed securities in the EU". Responding to the political calls for the revival of securitisation in the EU, the Commission published a consultation paper[9] in October 2024. The consultation effectively puts the current regulatory framework in its entirety up for discussion and could mark a further departure from the international standards:

- Less stringent due diligence requirements for investors, to encourage smaller investors into the securitisation market
- Less stringent transparency requirements, including initial and continuous disclosures and reporting for certain categories of transactions
- Expansion of the definition of 'public securitisation' to cover a broader spectrum of transactions, including Collateralised Loan Obligations (CLOs)

[3] European Council, Special Meeting of the European Council – Conclusions, 18 April 2024.
[4] Finance Watch, Europe's Coming Investment Crisis: Capital Markets Can Only Match a Third of EU's Essential Needs, 16 July 2024.
[5] Draghi, M., The Future of European Competitiveness. Part B: In-depth Analysis and Recommendations, September 2024.
[6] ESMA, Building More Effective and Attractive Capital Markets in the EU, Position Paper, 22 May 2024.
[7] Finance Watch, Europe's Coming Investment Crisis. What If Capital Markets Could Only Meet a Third of Europe's Essential Funding Needs?, 16 July 2024.
[8] Finance Watch, Lost Momentum. The Evolution and Challenges of Basel III, 24 September 2024.
[9] European Commission, Targeted Consultation on the Functioning of the EU Securitisation Framework, 09 October 2024.

- Relaxation of the homogeneity requirements for underlying assets in the criteria for simple transparent and standardised (STS) securitisations
- Creation of a pan-European securitisation platform, possibly supported by public guarantees, to stimulate a pan-European market and encourage standardisation
- Reduction of the risk-weight floor in certain circumstances, e.g. where an originating bank is the lender in the underlying loan transaction, as recommended by the European Supervisory Authorities (ESAs)
- Reduction of the 'p-factor' in the capital charge calculation, a measure frequently proposed by the banking sector but not endorsed by the ESAs
- Replacement of the structured ('mechanical') tests for 'significant risk transfer' by a 'principle-based' approach

II. Key policy issues

A. Capital Markets Union (CMU)

1. Actual capacity to contribute to the CMU

In 2022, the Joint Committee of ESAs observed that *"the development of the market following the introduction of the STS framework has been limited compared to the original objectives to generate between EUR 100-150bn in additional funding for the economy."*[10] The actual contribution of traditional securitisation to the EU capital markets so far has been rather limited. Less than half of the total outstanding volume of EU securitisation, and only ca. 30% of total issuance in 2023 (ca. EUR 60 bn), has been placed in the market. Originating banks prefer to retain these securities as collateral to obtain central bank liquidity through securities financing (SFT or 'repo') transactions.

Synthetic securitisation does not raise any external funding for businesses and households; it merely transfers the associated credit risk to (usually) one of a limited number of institutional counterparties to release regulatory capital for the originating bank. In either case, regulatory capital released through (traditional or synthetic) securitisation is not necessarily redeployed as lending to the real economy. In recent years, EU banks have massively increased their distributions to investors (to 50-60% on average), a trend that has attracted the attention of both European and international supervisors.[11]

2. Challenging economics of securitisation

Securitisation is a relatively expensive refinancing tool. The one-off cost of setting up a Special Purpose Vehicle (SPV) is considerable (legal fees, registration), as are the recurring costs of employing financial advisors, underwriters, credit rating agencies, independent trustees, administrators, accountants and auditors. These costs reduce the income

[10] Joint Committee of European Supervisory Agencies, Joint Advice on the Review of the Securitisation Prudential Framework (Banking). Response to the Commission's October 2021 Call for Advice to the JCs of the ESAs, JC/2022/66, 12 December 2022, pg. 7.

[11] E.g. European Banking Authority, Risk Assessment Report 2023, December 2023, pgs.64-64; Gambacorta, L., et al., Low Price-to-Book Ratios and Bank Dividend Payout Policies, Bank for International Settlements, BIS Working Paper 907, December 2020.

available to investors and put securitisation at an inherent economic disadvantage compared to traditional debt instruments, such as covered bonds. Since most of these costs are fixed, their impact can be mitigated to some extent by spreading them over a larger issue volume. Accordingly, securitisation is mostly used by large, systemically important banks, which carry sufficiently large portfolios of suitable assets on their balance sheets.

Critically, securitisation becomes attractive for banks due to its positive effects on regulatory capital and financial performance metrics. Fees received for the origination of loans remain on the profit and loss account even if the underlying loan is subsequently removed from the balance sheet through securitisation. Regulatory capital that is released can either be returned to investors through dividends and share buy-backs, or used to originate new loans, generating additional fees in turn. Both mechanisms increase the bank's return on equity, a key metric observed by investors in bank equities and frequently used as a basis for the remuneration of bank staff and management.

3. Limited availability of suitable assets

The range of assets (loans) suitable for securitisation is limited. By far the most prevalent category is mortgage loans. In other areas, such as vehicle and equipment leasing, securitisation could address the specific needs of specialised financial institutions and may have a meaningful, albeit limited, role to play. Homogeneity of the underlying assets is a key criterion for the robustness of a securitisation, which is why suggestions to dilute the criteria for STS securitisations, labelled as particularly 'safe', is a major concern.

Securitisation of corporate loans, often promoted as a potentially attractive way for banks to refinance loans through the capital markets, has only limited potential to mobilise additional funding for corporates. For SME loans, in particular, inherent practical limitations constrain the size and relevance of this market: collateral is scarce and often has little or no alternative use; tenors are non-standardised; terms and conditions are bespoke. Progress on the harmonisation of contract and insolvency law and taxation would be a prerequisite to improve the feasibility of cross-border pooling and issuance of such securities.

There is a sizable market for CLOs, which is based on securitising (mainly non-investment grade) loans to larger corporates, usually related to Leveraged Buy-Out (LBO) transactions. These leveraged acquisition loans tend to be larger in size, and fairly standardised[12] but also inherently more risky, and therefore more vulnerable in the event of a cyclical downturn. There are also concerns that some non-banking financial institutions (NBFIs) may have provided credit protection through synthetic securitisation for LBOs where they are also the equity sponsor, thus accumulating 'circular' equity and credit risk exposures.[13]

[12] Industry standards, such as the Standard Term Sheet for Leveraged Acquisition Finance Transactions, issued by the Loan Market Association' (LMA), are widely applied.
[13] Financial Times, Blackstone Snaps up 'Circular' Private Equity Credit Risk, 03 July 2024.

4. Overlaps with established, well-functioning markets

Great expectations of the growth potential of securitisation in Europe derive from drawing comparisons with other jurisdictions, especially the US, which are invariably flawed. The US market, in particular, is based on unique public policy choices and government initiatives, especially in the housing market. In many EU member states, mortgage loans are refinanced using alternative instruments, especially covered bonds. As of 2023, the total volume of covered bonds outstanding from EU issuers was ca. EUR 2.2 tn, of which[14] 88% were backed by mortgage loans. The three largest global issuers of covered bonds are Denmark, Germany and France.[15]

Covered bonds constitute a large, liquid, and highly effective market. They contribute significantly to the availability of affordable mortgages in many EU member states. Their specific design (overcollateralisation, dual-recourse) makes them a high-quality asset in great demand by international investors. Built-in limits on leveraging the underlying collateral also act as a brake on the systemic build-up of leverage in the property market. Covered bonds allow a bank to refinance mortgage loans at very favourable terms - often better than its own corporate credit rating - but do not allow it to remove assets from its balance sheet and release regulatory capital, which is a priority for large banks, in particular.[16]

5. A securitisation platform with public support?

Some commentators, especially Noyer,[17] have made the argument for a European equivalent to the US government-sponsored entities (GSEs), such as Fannie Mae and Freddie Mac. They suggest that a pan-European platform should be established to facilitate the issuance of standardised pan-European securitisations, supported with public guarantees, e.g. from public development banks, both at national and EU-level. They argue that such a platform would foster the emergence of a deep, liquid securitisation market, and offer cost-sharing benefits for smaller banks.

This proposal effectively returns to the principle of 'privatising profits and socialising risk', which many thought had been well and truly discredited after the global financial crisis of 2007/09. Instead of providing public support directly to the real economy, this proposal would once again place the public at risk in order to 'de-risk' the business of the banking sector. This risk to the public is real: in September 2008, the US government had to place Fannie Mae and Freddie Mac under 'federal conservatorship' (i.e. administration). The two entities, previously stock exchange-listed, were effectively nationalised and USD 200 billion was committed by the US Treasury to compensate for their losses and keep them operational.

[14] European Covered Bond Council (ECBC), Covered Bond Yearbook 2024, 29 August 2024.
[15] European Covered Bond Council (ECBC), Covered Bond Yearbook 2024, 29 August 2024.
[16] E.g. in France, where some of the largest EU banks play a significant role in the domestic mortgage market, the covered bond market has stagnated in recent years while MBS issuance has grown significantly.
[17] Noyer, C., Developing European Capital Markets to Finance the Future: Proposals for a Savings and Investment Union, April 2024, pg. 7.

The discussion about a possible securitisation platform backed by public guarantees in the EU has implications for public sector budgets - both at the EU and member-state level. The feasibility of the public guarantee solution is questionable in the current situation, where member states remain constrained by debt and deficit limits, the EU's own resources are limited, and member states remain at a political impasse over possible EU-wide risk pooling in the financial sector.

6. Impact on 'relationship banking' (households and SMEs)

When considering the suitability of certain loans for securitisation, it is important to bear in mind that, in a traditional, 'true sale' securitisation, the sale to a third party (the Special Purpose Vehicle, SPV) severs the relationship between the lender and borrower. Even if the originating bank continues to service the loan on behalf of the SPV, it no longer has the autonomy to amend or modify the loan agreement, e.g. extend its maturity or grant a payment holiday. The SPV, in turn, has little room for manoeuvre and little incentive, given its commitments to investors, e.g. to grant forbearance. As a result, lenders are more likely to call in the loan and seize their collateral, a step that is already very painful when applied to a typical consumer or SME loan, and potentially traumatic when applied to a mortgage. Therefore, the concept of 'relationship banking', which is often invoked as being key to retail and SME banking in Europe, does not sit well with securitisation.

B. Financial Stability

1. Leverage

At the asset/loan level, securitisation encourages higher leverage as it is not bound by statutory leverage limits, which characterise other collateralised debt instruments. Covered bonds, in particular, are subject to legal loan-to-value (LTV) caps, which ensure a degree of overcollateralisation and protection against property market cyclicality.[18] The private mortgage backed securities (MBS) market offers refinancing options for more aggressive mortgage lending, which encourages borrowers to take on higher levels of debt. In corporate lending, securitisation through CLOs enables banks to structure acquisition funding for LBOs, which often absorb a significant portion of investee companies' operating cash flow, leaving them short of funds for investment and financially fragile in a downturn.

At the aggregate level, the ability of banks to originate loans and sell them on to capital market investors, or pass on the attendant credit risk in the case of synthetic securitisation, moves credit risk from the banking to the 'shadow banking' (NBFI) sector. More fragmented and less transparent, the NBFI sector is not subject to the same degree of prudential regulation and consolidated supervision. The build-up of excessive leverage in some segments of the NBFI market, especially through the use of derivatives, has the potential to amplify shocks and exercise strong procyclical pressure in a downturn.[19] This

[18] 'Conforming' mortgage loans eligible for securitisation by US government-sponsored agencies are also subject to LTV limits.
[19] Finance Watch, A Missed Opportunity to "revive" boring finance?, pgs. 35-40.

could, through its linkages with the banking sector, jeopardise the stability of the financial system.[20]

2. Concentration risk

Actual practices in the EU securitisation market do not align well with its stated objectives of shifting credit risk off banks' balance sheets, and widely distributing it across the financial system. In its 2022 report on systemic risk in the securitisation market,[21] the European Systemic Risk Board (ESRB) noted that *"ten banking groups held 84% of the total holdings of EU RMBSs in the euro area"* and concluded that this *"concentration observed across and within member states, including retained self-securitised loans, indicates that the benefits [of securitisation] are not being reaped"*. Another area of concern is the potential concentration of derivative exposures, especially from synthetic securitisation. Investors in this market mainly tend to be specialised funds and asset managers,[22] a worrying parallel with 'monoline' insurers providing credit protection for securitisation portfolios before the 2007/09 crisis.

3. Regulatory capital arbitrage

The fact that securitisations are being originated and mostly bought and held by banks in the EU (as highlighted above) implies a complex mechanics of capital requirement calculations, which offers the potential for regulatory capital arbitrage. The originating bank reduces its credit risk exposure and frees up regulatory capital - either by removing securitised assets from its balance sheet (traditional/true-sale) or by transferring the risk of such assets (synthetic transaction). Yet, by buying securitised assets originated by other banks, the bank obtains a different securitisation exposure subject to a different capital requirement - depending on the seniority/rating of the security, and on whether the bank holds securitised assets in its banking or trading book. Securities held in the trading book can be pledged as collateral under securities financing or repo transactions.

Conclusion

Finance Watch believes that policymakers' emphasis on securitisation is misguided. The potential contribution of securitisation to the CMU is doubtful and, in any event, limited. As of today, less than one-third of European securitisations are actually placed on the market, raising little more than EUR 60 bn of fresh capital.

There are other, more pressing concerns to be addressed to (a) meet the funding challenges of the near future and (b) build a useful, stable and effective CMU. Member states will have to face difficult choices and compromise on matters of national interest.[23] Further harmonisation (e.g. of company, insolvency and tax law), as well as a move towards

[20] E.g. in the failures of Long Term Capital Management (1998) and Archegos Capital Management (2021).
[21] European Systemic Risk Board, Monitoring Systemic Risk in the EU Securitisation Market, July 2022, pgs. 4 and 52.
[22] Gonzalez, F./Triandafil, C., The Evolution of the SRT Market (2018-2022), ESRB Occasional Paper No. 23, 03 October 2023, pg. 30.
[23] Bini-Smaghi, L., The Political Economy of the Capital Markets Union, Institute for European Policymaking (IEP) Policy Brief, June 2024.

common market infrastructures and supervision, is essential. Meanwhile, EU policymakers should not cause severe collateral damage to other well-functioning segments of the European capital markets, such as covered bonds, and to the real economy more widely, especially the housing sector.

Whereas Finance Watch fully supports the call for a stable, profitable, and competitive European banking sector, it must not come at the expense of European citizens. A successful EU banking sector can only be built on a bedrock of financial stability. Post-crisis measures to address the risks of securitisation were agreed and enacted through regulatory cooperation at the global level and should be reviewed and amended in the same way. Going it alone on prudential regulation, and entering a cycle of 'tit for tat retaliation' with other jurisdictions, is only going to trigger a deregulatory 'race to the bottom', which has no winner, but many losers. EU legislation already deviates from the Basel III standards. EU legislators should engage with other jurisdictions to return towards regulatory convergence instead of departing even further from global standards.

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